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Cosmetics and Tricks: Representing the Meanings of Earning Management Practices

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Abstract

The purpose of the study is to expose the meanings of earning management practices based on the perspective of the users of financial statements. By utilizing a qualitative approach, the study collects data based on the experience and perception of informants. Through in-depth and unstructured interviews, data are collected from tax inspector, credit analyst, investor, public accountant, and accounting lecturer. The study exhibits that, earning management is a creativity of management in manipulating and engineering accounting numbers with an intention to present a beautiful and attractive profit to external users. It is a sort of fraud that functions as cosmetics and tricks to deceive others for the benefits of manager or management.

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1. Introduction

Management may apply accounting techniques on recognizing revenues and expenses to provide accounting information, especially earnings, for external users. The purpose of the practice is actually to create a positive image to external parties about a managerial performance. The practice is commonly known as earning management. It is hard to differentiate whether the practice is fraud or not. But, it is possible that the practice is understood as choosing accounting policies (Scott 2003: 369). Consequently, it is technically and legally correct and cannot be classified as

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fraud. Nothing wrong with the practice! However, if the practice is done with an intention to deceive other parties, then there should a practice of fraud.

Many works have been done on this topic (Grasso et.al., 2009; Jiraporn et.al., 2006; DuCharme et. al., 2004; Beneish 2001; Kaplan 2001; Bell & Carcello 2000). Kaplan (2001), for example, argues that the practice of earning management has positive and negative sides. The positive side perceives that the practice is a legitimate product, while the negative side deems it as immoral and unethical attitudes. Those who opine in a positive side argue that earnings management is a professional judgment on preparing financial statements for external parties that is conducted by applying accounting policies. As long as the policy is in accordance with accounting standards, then the practice is considered as a legal practice and in average is not injurious (Jiraporn et.al 2006).

On a negative side, some argue that earning management is a practice of increasing or decreasing profit for the sake of management interests (DuCharme et. al. 2004; Beneish 2001; Schipper 1989). It is done, because management is under a pressure of others (Bell & Carcello 2000). Earning management is not a good practice, because it may mislead stakeholders in interpreting the economic performance of a company to a mistaken direction. Consequently, they may make wrong economic decisions. It is considered as an act of misleading and deceiving stakeholders (Grasso et.al, 2009) and therefore it is an illegal, immoral, and unethical practice.

Healy & Wahlen (1999) and DuCharme et. al. (2004), in a neutral position, explicate technically the practice of earning management. For them, earning management is a practice of income increasing by shifting future income into current income or shifting current costs into future costs, so that earnings in the current period is reported higher than it should be or otherwise.

As exposed above, we believe that there are various perceptions on the practice of earning management. The perceptions are socially constructed. It means that a researcher in a certain social context may find different meanings of earning management with others. Social contexts may craft the way of a person to interpret the practice of earning management. However, social contexts are just external parts, in spite of internal character, of a person in interpreting and understanding the practice of earning management.

This study is concerned with digging the meanings of earning management based on the experiences of the users of financial statements in social contexts. The users include tax inspectors, credit bank analysts, public accountants, accounting lecturers, and investors. They are the professionals who have experiences in using their client's financial statements for their businesses.

2. Research Method

2.1. Qualitative Research

This study employs a qualitative approach. It is, according to Creswell (1998:15), a process of research and understanding based on a methodology that investigates social phenomena and problems of human. Technically, it is a research procedure that tries to express scientifically the uniqueness of an individual, group, community, and organization in daily life and in a particular setting (Miles & Haberman, 1992: 5). Bogdan & Taylor (1992:22) also argue that qualitative research is capable of producing an in-depth description of observed speech, writing, and behavior.

In qualitative research, the researcher is the key instrument. A researcher should have a provision of theories and insights related to the social context studied. Insights are in the forms of value, culture, belief, law, custom occurring and evolving in a particular social context. Based on the theory and insights, the researcher can ask, analyze, and construct the object scientifically.

2.2. Informant and Data Collection Method

Selection of informants was done deliberately and purposively based on certain criteria. In a purposive sampling technique, informants are selected based on certain criteria to get deep information in the area of an observed phenomenon Neuman (2006:222). Firstly, the subject has been quite long and intensively involved in the targeted research activities. Secondly, the subject is still actively involved in environmental or activities that are the focus of research.

Informants in this study are the users of financial statements who utilize and feel directly or indirectly the presentation of the financial statements. The informants are presented in Table 1.

Table 1: A List of Informants

No.	Names*)	Profession
1	Djoko	Tax inspector
2	Widodo	Credit analyst
3	Prabowo	Investor
4	Hardianto	Public accountant
5	Nurshanti	Accounting lecturer

(*) The names of the informants are pseudonym

The study is concerned with the perception and understanding of tax inspector, credit analyst, investor, public accountant, and accounting lecturer regarding the practice of earning management. Data are collected from the informants by using in-depth and unstructured interviews. Data collected are mostly in terms of words. Other data that also become our concerns are the informants' expression and attitude.

In-depth interview is based on unstructured but focused conversations in the area of earning management and conducted under a very relax and informal condition to gain natural and fair information. So, the interview seems to be a daily conversation among our colleagues.

2.3 Data Analysis

In this study, we use Miles & Huberman's (1992:15-21) method of analyzing data. The procedure of analyzing data includes (1) data reduction, (2) presentation of data, and (3) conclusion or verification. Data are analyzed in such a way that finally we catch the meanings of earning management according to each informant mentioned above.

3. Findings and Discussion

The following sections are the explorations of the meanings of earning management under the perspective of the users of financial statements.

3.1. A Tax Inspector: Earning Management is Earning Manipulation and Fraud

Djoko, a tax inspector, perceives that earning management is the same as earning manipulation. The major reason of his perception is that it is a practice of violating generally accepted accounting principles. In this respect, Djoko argues:

> "For me, earning management is a diplomatic word of earning manipulation. Why do I say that? Because, the practice is not accordance with accounting principles…[it's really a manipulation]… and I know this fact when I did my inspection on taxpayers' annual tax return and financial statements. Even though the practice is not based on manager's motivation for personal gain, but it is still illegal, because it violates the rules".

Djoko's understanding of that earning management violates generally accepted accounting principles is different with previous works of some researchers. The previous works argue that the practice is still in compliance with accounting standards, because the practice just involves in choosing accounting standard method. Thus, the practice is legal. But, Djoko has a strong reason to say that the practice is fraud and thus illegal. Djoko explicates:

> "Based on my experience in examining taxpayers' financial statements, I really comprehend that they make double bookkeeping that consequently they have two kinds of financial

> statements [one is prepared for management and the other is for government]. The practice exactly violates generally accepted accounting principles [and government's rule]."

Djoko's argument is reasonable, because of preparing two sorts of financial statements with different purposes is clearly a practice of manipulation and fraud. But, ironically it is not a secret practice in business society. It could be a common practice to prepare two sorts (and maybe more than two) of financial statements for different purposes. Djoko finds that earning management is done by mostly family companies that basically they are not listed in Indonesia Stock Exchange (IDX). Possibly, they do not have any knowledge in government law that regulates the practice of preparing financial statements. Djoko further explains:

> "I think unlisted companies [family-owned companies] that practice earning management is higher than listed companies. It's because of their financial statements are not audited by a public accountant. Management of unlisted companies does financial engineering that is exactly a practice of fraud…"

Based on the above description, we can draw a tax inspector's perception on the practice of earning management. For the inspector, earning management is a practice of manipulating accounting numbers related to a presentation of earning information. The practice is classified as fraud, because it breaks accounting standards and government law.

3.2. A Credit Analyst: Earning Management is Cosmetics

Widodo, a credit analyst of a bank, interprets the practice of earning management as cosmetics. The function of the cosmetics is to make something beautiful. In the context of earning management, cosmetics are something utilized by management to make financial statements, especially the information of earning, more beautiful and attractive. Management, in this respect, acts as a beautician. Management has an expertise to paint financial statements in colorful and beautiful appearance. Widodo says:

> "I think all ladies certainly know the function of cosmetics. Cosmetics are useful to make a lady to be more beautiful and attractive…a lady may be not really pretty, but because of she makes up her face, then she looks pretty…"

Cosmetics metaphor can be applied to, for example, a company that is trying to propose a bank loan. Of course, the company's management does its best to get approval. To get the loan, the management may make earning management. Widodo further explains:

> "… by hoping that the proposal will be approved by the bank, management makes the company's financial statements looks like more beautiful and more profitable to convince the bank… it's cosmetics! that's the way of beautifying financial statements…"

Cosmetics do not only make a lady's face looks beautiful, but also ugly. How come? Earning management can be used to make financial statements seems to be good or bad depending upon the purpose of the management. If the management has an intention to get a bank loan, then earning management can be done exposing an increasing profit of the company. But, if the management intends to reschedule the bank loan, then the management should report an increasing loss. Regarding this, Widodo asserts:

> "Earning management is not only related to report an increasing profit, but also an increasing loss. Reporting an increased loss is needed when the company has a decreasing capacity to pay its debts that are nearly due date… by doing this, the company tries to negotiate bank to reschedule its installment."

Thus, we infer that Widodo as a credit analyst realizes the practice of earning management as cosmetics. Earning management is a practice of reporting profit or loss in financial statements for the sake of management. When a management of a company intends to get a bank loan, then the management can make financial statements looks beautiful and attractive. Such financial statements will attract management of a bank to approve the company's proposal. But, if the company has a difficulty in repaying its bank loan, then the management of the company can make the financial statements look bad by reporting loss. Therefore, to be beautiful or ugly depends upon the intention of the company's management.

3.3. An Investor: Earning Management is a manager's trick to deceive others

Prabowo, an investor, interprets earning management as a manager's trick that is deliberately undertaken for the sake of managers at cost of others. Prabowo says:

> "…talking about earning management, I remembered my experience a few years ago that disappointed me. I got a big loss on my investment in a company…[I tried to meet the company's manager, but I couldn't] I just found his photo. I broke the photo [and I said "fuck you…]."

Prabowo continues to tell his story: "This is the job of the manager. He is very smart to make a trick on financial statements. He makes them look good, but in fact the company's financial condition is very bad. He cheated other people and me by presenting very good financial statements. I bought the company's common shares, but a few days just after that, the market price of the shares was dropped…"

Prabowo continuously tells us his story: "I know, a manager is also a human being. He has desires and personal interests. He uses his power to raise and lower the company's profit numbers to fulfill his ambition, say to gain bonuses or to maintain his position as a manager. He tries to present his performance looks good…"

A trick is a way for a manager to deceive other people for his/her-own benefits. The manager does not care of the interests of investors and other stakeholders. What he/she thinks is how he/she makes tricks to benefit his/herself. Prabowo is a victim of manager's tricks. There could be other investors who have the same fate as Prabowo, i.e, the victims of manager's tricks on financial statements. For Prabowo, a tricks is the meaning of earning management.

3.4. A Public Accountant and an Accounting Lecturer: Earning Management is a Practice of Profit Engineering

A public accountant and an accounting lecturer interpret earning management as profit engineering that is done by playing accounting numbers. Hardianto, a public accountant, utters:

> "When I heard the word 'earning management,' then it comes to my mind 'it's profit engineering.' Why do I call it 'engineering?' Because managers usually engineer accounting numbers in financial statements look so good. The engineering is not done by choosing accounting policies and even extremely breaking the rules in accounting standards."

The same opinion is also delivered by Nurshanti, an accounting lecturer in a university. For Nurshanti, earning management is profit engineering that breaks the rules in accounting standards. She says: "I think earning management is a management's game that is run by playing accounting numbers to present a company's good performance in front of public. In doing so, management does not only change accounting policy but also engineer accounting numbers of revenues and expenses that do not really happen."

Other explanation of Hardianto gives us a clear insight that the practice of earning management is done to get a bank loan. This understanding is the same as disclosed by Widodo who is a credit analyst in a bank. Hardianto explains: "At the time of proposing a bank loan, the company's management makes earning management by presenting a good performance of financial statements. Management manipulates earning numbers by reporting fictitious revenues and deferring expenses."

Hardianto and Nurshanti have the same interpretation on the practice of earning management i.e., profit engineering. For them, it is a practice of engineering profit numbers by manipulating accounting numbers on revenues, and even making fictitious revenues, and deferring expenses to present a good performance on profit. This is the product of earning management.

Table 2: The Meanings of Earning Management

No.	Name	Profession	The meanings of earning management
1	Djoko	Tax inspector	Earning manipulation and fraud
2	Widodo	Credit analyst	Cosmetics
3	Prabowo	Investor	Tricks to deceive others
4	Hardianto	Public accountant	Profit engineering
5	Nurshanti	Accounting lecturer	Profit engineering

Table 2 exhibits the meanings of earning management for each informant. In essence, earning management is a negative creativity of management to manipulate and engineer accounting numbers with an intention to present a beautiful and attractive profit to external users. It is a sort of fraud that functions as cosmetics and tricks to deceive others for the benefits of management.

The findings demonstrate that all informants have negative meanings of earning management. These findings support the works of Grasso *et.al*, (2009), DuCharme *et. al*., (2004), Beneish (2001), Bell & Carcello (2000), and Schipper (1989) that basically recognize earning management as an unethical and illegal practice. In contrast, the study is in an opposite position of those who say that earning management is a legal practice (Jiraporn et.al 2006). This study is also in a different position with those who accepting earning management as a technical and neutral practice (Healy & Wahlen 1999 and DuCharme *et. al*. 2004).

4. Conclusion

The study presents various meanings of earning management. The variety may be caused by various experiences, stock of knowledge, and personality of the informants. Accordingly, one symbol may be interpreted in a different way and meaning. But, in essence all informants recognize earning management as an unethical and illegal practice.

In short, the study finds that earning management is a negative creativity of management to manipulate and engineer accounting numbers with an intention to present a beautiful and attractive profit to external users. It is a sort of fraud that functions as cosmetics and tricks to deceive others for the benefits of management. This is the new meaning of earning management that is successfully constructed by the study. However, the finding is of course socially bounded because the study is conducted in a certain social-economic context that may be different with other social reality.

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